House Budget Committee
Democratic Caucus
U.S. Rep. John Spratt ■ Ranking Democratic Member

January 27, 2000

Analysis of New CBO Surplus Estimate

Dear Democratic Colleague,

On Wednesday, the Congressional Budget Office (CBO) released its latest estimates for the budget surplus. CBO's new estimates are approximately $1 trillion more optimistic than the projections they released just six months ago. While the new surplus estimates are good news, claims of a $2 trillion surplus are unrealistic.

CBO laid out three different spending baselines and came up with ten-year on-budget surpluses ranging from $800 billion to $1.9 trillion depending on the baseline CBO used. The three baselines were as follows: (1) "zero real growth baseline," which assumes Congress will increase discretionary spending only to keep pace with inflation; (2) "hard freeze," which assumes a 10-year freeze at the FY2000 funding level with no increase to cover inflation; (3) "capped baseline," which assumes we stick to the spending caps until they expire in 2002 and then increase discretionary spending only to keep pace with inflation.

Only the first one of the three alternatives represents a realistic starting point for analysis – the baseline that maintains constant purchasing power for appropriations. This baseline shows how much it will cost in the future to do what we're doing today. The other two baselines assume that programs will be cut to a degree that Republicans never have been willing to cut in the past. In fact, since Republicans gained the majority of Congress, appropriations have increased faster than inflation.

Republicans will advocate using the baselines that suggest that future surpluses will be huge because of future, unspecified program cuts. This will allow them to claim that they can have exploding tax cuts, rebuild our military strength, and still have enough left over to pay down the public debt. But last year, we saw Republicans pass a budget resolution that assumed deep discretionary cuts they were unwilling to enact when Congress considered appropriations bills later in the session.

The attached analysis and graphs prepared by the House Budget Committee's Democratic staff outline the implications of the three baselines and show why only one of them is realistic. It also discusses how the rather large upward revision in the projected surplus from just six months ago reinforces the fact that such long-range forecasts are inherently precarious. Finally, it notes that the improved budget outlook doesn't materially change the serious long-term challenges facing Social Security and Medicare. For all of these reasons, the Congress should proceed cautiously with regard to committing a future surplus that may not materialize.

I hope this information is helpful. If you have any questions, please feel free to call me or have your staff call the Budget Committee staff at x67200.

Sincerely,

John M. Spratt, Jr.
Ranking Democratic Member

Summary

CBO laid out three different spending baselines and developed ten-year on-budget surpluses ranging from $800 billion to $1.9 trillion depending on the baseline used. The three baselines were as follows: (1) "zero growth baseline," which assumes Congress will increase discretionary spending only to keep pace with inflation; (2) "hard freeze," which assumes a 10-year hard freeze at the FY2000 funding level; and (3) "capped baseline" which assumes we stick to the spending caps until they expire in 2002 and then increase discretionary spending only to keep pace with inflation.

Only one of the three baselines reported by CBO, i.e. the baseline that assumes constant purchasing power for appropriations, is a realistic starting point for budget planning.

- Assuming constant real (i.e. inflation-adjusted) spending for appropriations, CBO projects that the non-Social Security Surplus will be $11 billion in 2001 and $838 billion over the next ten years. Using this baseline, CBO projects that the total (i.e. unified) surplus will be $177 billion in 2001 and $3.2 trillion over ten years.

The "freeze" baseline, in which appropriated funding is held constant for the next ten years, implies cuts in real purchasing power that Republicans never have been able to make. Holding total appropriations at a constant nominal level while increasing defense spending just to cover inflation would require cuts in real non-defense appropriations of 40 percent by 2010.

- Assuming a "freeze" baseline, CBO projects that the non-Social Security surplus will be $22 billion in 2001 and $1.9 trillion over ten years. Using this baseline, CBO projects that the total (i.e. unified) surplus will be $188 billion in 2001 and $4.2 trillion over ten years.

The "capped" baseline is unrealistic. In order to adhere to the appropriations cap currently in law, Congress would have to cut appropriations from last year's level of $603 billion to $578 billion in 2001 and to $571 billion in 2002.

- Assuming a "capped" baseline, CBO projects that the non-Social Security surplus will be $69 billion in 2001 and $1.9 trillion over ten years. Using this baseline, CBO projects that the total (i.e. unified) surplus will be $235 billion in 2001 and $4.2 trillion over ten years.

Only One of the Three Baselines is Realistic

I. The "<u>capped baseline</u>" is unrealistic because it assumes rigid adherence to the caps until the caps expire after 2002 and assumes no emergencies in any year.

- Over the last two years, Congress evaded the caps by tens of billions of dollars by using emergency designations for ongoing, routine costs and by shifting costs from one year to the next.

- Last year, the appropriations bills the Republicans sent to Clinton exceeded the initial outlay caps and their own budget resolution by $30.7 billion. The final bills exceeded the outlay caps by $34.8 billion.

- A capped baseline requires cutting the real purchasing power of appropriated programs by 12 percent by 2002. Actual outlays in 2000 are estimated to be $602.7 billion. Adherence to the caps would require that outlays be reduced to $578.5 billion in 2001 and to $570.9 billion in 2002.

II. The "<u>freeze baseline</u>," which assumes that funding for appropriated programs will be frozen for ten years, also is unrealistic.

- A ten-year freeze means a cut in purchasing power of 21 percent by 2010.

- If *total* appropriations are frozen for ten years but defense is increased to cover inflation, the cut in non-defense purchasing power is 40 percent by 2010.

III. The "<u>inflation-adjusted baseline</u>" that assumes constant purchasing power for appropriations is the only realistic baseline. And even it does not reflect the historical record of positive real growth, nor does it provide for major natural disasters or military operations.

Average annual increase in outlays for non-defense appropriations

	1995-2000	1991-2000
nominal increase	3.3%	4.6%
real increase	1.3%	2.2%

Defense appropriations are also programmed to increase in purchasing power, now that the build-down following the end of the Cold War has been completed.

Average annual increase in outlays for defense appropriations

	1998-2000
nominal increase	2.3%
real increase	0.6%

$1 Trillion Revision Illustrates the Unreliability of 10-Year Forecasts

- A $1 trillion upward revision of the surplus from its level just six months ago shows that 10-year budget projections are precarious and unstable.

- Revisions of the budget outlook in recent years have been favorable, but there is no guarantee that revisions will not turn against us in the future.

- All projections involve assumptions, and the role of assumptions increases the farther into the future one projects.

- Very small changes in assumptions can have very large effects when projected over periods as long as 10 years. For instance, if one assumes that ***nominal*** GDP grows 0.1 percent less, that small change deducts $150 billion from the 10-year surplus.

- CBO has changed its assumption about long-run productivity growth, and that change is primarily responsible for the large upward revision. Productivity growth averaged 1.6 percent during the 1970s, 1980s, and early 1990s, but it has accelerated to a 2.6 percent rate over the last four years. CBO is now projecting that productivity growth will average 2.2 percent over the next ten years.

- The size of the upward revision is large irrespective of which baseline concept one uses. Whether you are using a capped baseline, a zero real growth baseline, or a freeze baseline, the upward revision is still approximately $1 trillion.

- Given the uncertainty of long-range forecasts, Congress should be cautious about permanent fiscal changes, like large and expanding tax cuts committing major portions of a surplus that may not materialize.

Social Security and Medicare Still Face Major Challenges

- Seventy percent of the improvement in the projected surplus is outside Social Security. Social Security's finances still face major challenges.

- The reason is that payroll taxes do not apply to earnings above $76,200. Though some workers below that level have enjoyed higher earnings, much of the unexpected income growth has gone to the affluent either as earnings or other forms of income.

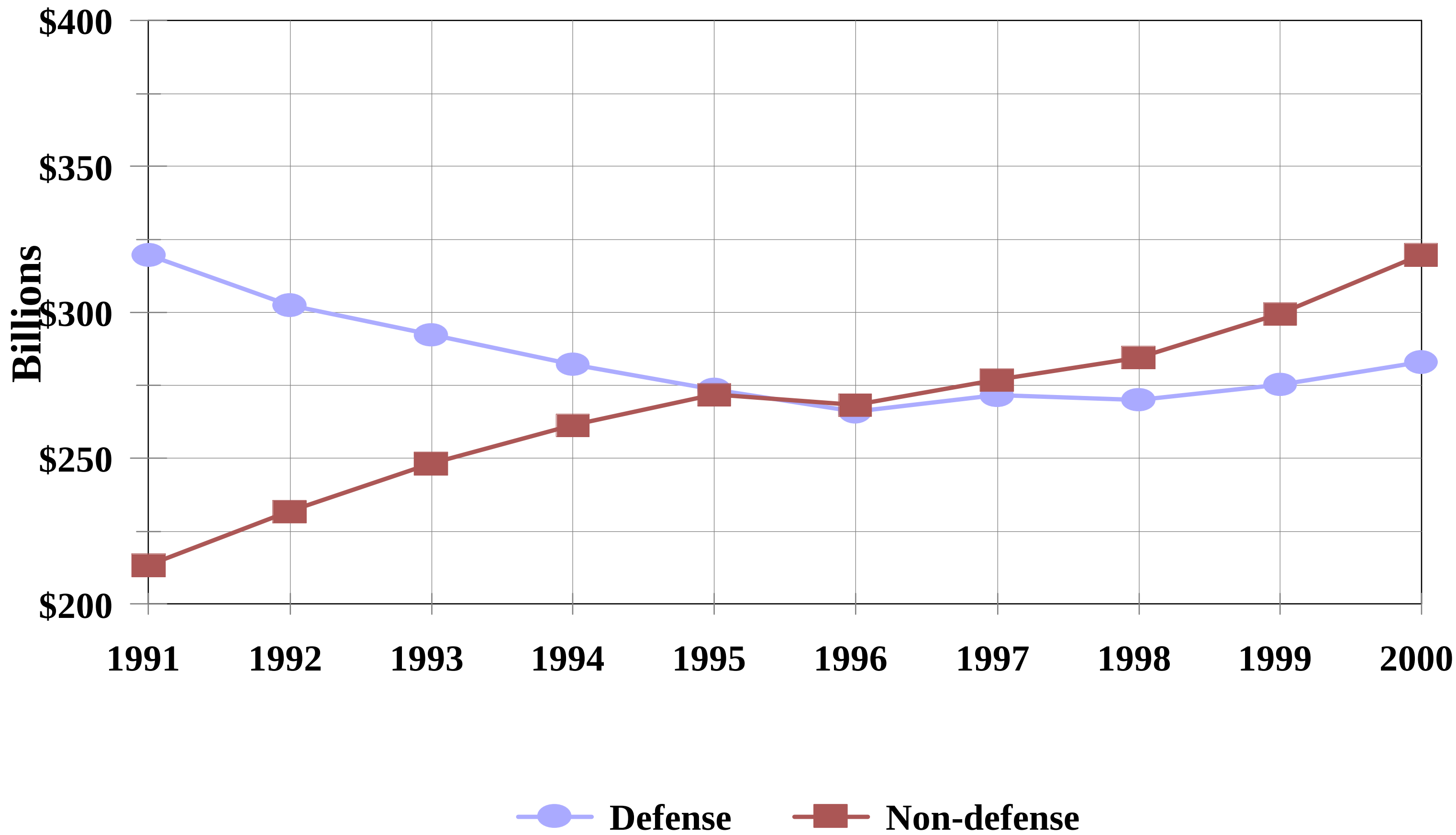
- The improvement in the non-Social Security surplus improves the prospects for Social Security only if some portion of it is reserved for that purpose.

- Projections for Medicare have improved a bit more than for Social Security, but the program still faces major challenges.

- The reason that Medicare's prospects have improved is that payroll taxes for Medicare apply to earnings at all levels. In addition, CBO is assuming a more modest re-acceleration of health care costs.

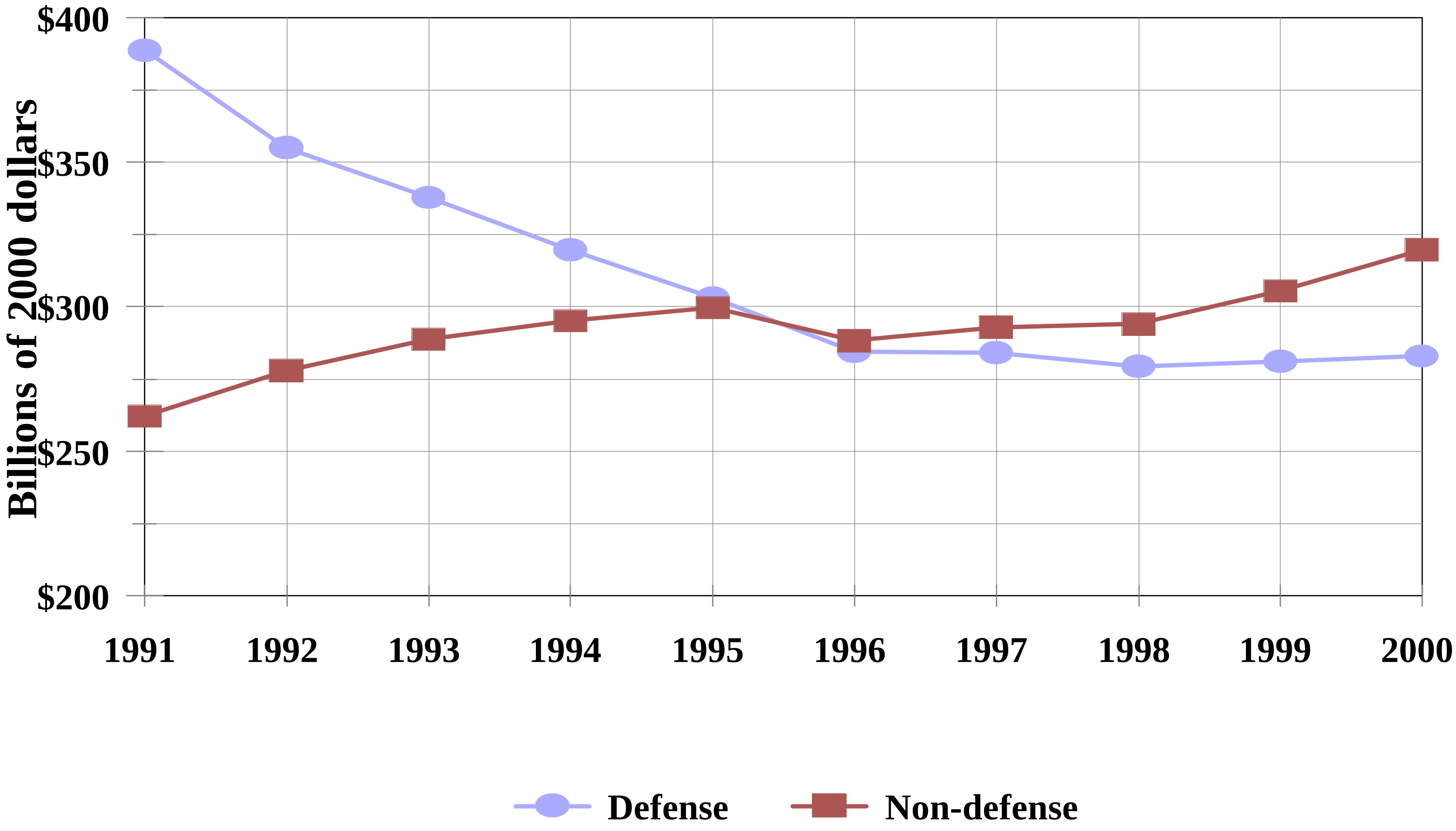
House Budget Committee Democratic Staff
January 27, 2000

1. Outlays for Appropriated Programs
Current (nominal) dollars



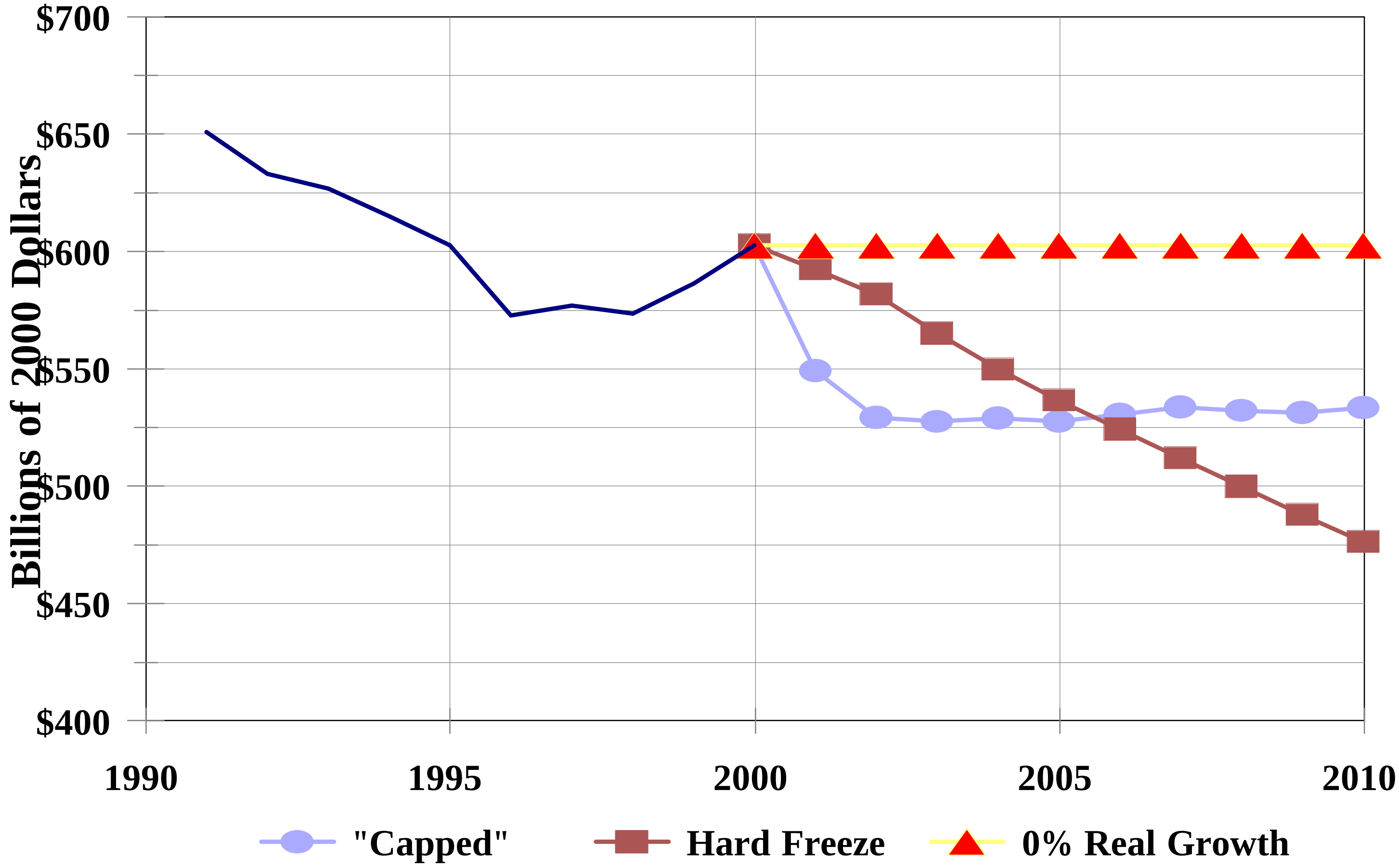
2. Outlays for Appropriated Programs

Constant (real) dollars



3. Alternative Projections

Constant (real) dollars



4. The Freeze, Defense, & Non-Defense

Real Outlays for Appropriated Programs